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The usual effect of the attempts of government to encourage consumption, is merely to prevent saving; that is, to promote unproductive consumption at the expense of reproductive, and diminish the national wealth by the very means which were intended to create it. What a country wants to make it richer is never consumption, but production. Where there is the latter, we may be sure that there is no want of the former.

John Stuart Mill, *Of the Influence of Consumption on Production*, 1844

TAILSPIN

It has rather grudgingly been accepted that the U.S. economy is in recession. But this announcement has caused little more than a yawn among people and in the markets. Claiming to be principally attuned to looking forward, Wall Street keeps its eyes preferably on the generally predicted and expected V-shaped(!) recovery.

It has now been 12 months since the Fed made the first move of its current monetary easing campaign, yet the data show that downward forces keep worsening. Can this still be explained away with the gospel of a normal policy lag? The trouble is that even the regular, prompt transmission effects of monetary easing in the financial markets are missing.

What is the possibility or probability of the U.S. economy's V-shaped recovery that the consensus is betting on? This letter explores the pattern and the conditions under which five postwar recoveries of this kind came about. The precedents allow no other conclusion than that such a recovery is completely out of the question this time.

What about a slow recovery, as happened after the 1990-91 recession? There will certainly be fluctuations, but we doubt even the possibility of a sustained slow recovery. There is one key difference between now and the last recession: Profits never declined during that downturn, and they soared when it ended. This time, profits are in an unprecedented tailspin, for which there is no end in sight.

AN UNUSUAL PATTERN

Faith in the doctor tends to fade when the medicine that he prescribes fails to show any desired effects. Not so in the case of Doctor Alan Greenspan. Though he has pumped cheap and loose money into the U.S. economy with a speed and aggressiveness that has no precedent in history, the desired effects remain completely missing. The downturn is even accelerating. Yet faith in his magic appears unshaken.

The general great hope is the consumer. In fact, he has been getting a financial lift from several sources of almost astronomical size. Mortgage refinancing, falling energy prices and the government's tax rebate program combined to pump more than $300 billion into household buying power last year.

For sure, that's an impressive sum. For perspective, however, consider the following: During 2000, total consumer purchasing power increased more than $1,085 billion, of which $542 billion had derived from current income growth and another $543 billion from new borrowing. But his income is now stagnating.

Let us briefly take stock of what has happened to the economy. From1998-2000, U.S. real GDP grew at an annual rate of 4.1%. In the third quarter of 2001, it was negative at 1.1% annual rate, as against 4.7% in the same quarter a year ago. ***This is the steepest decline in economic growth that has ever happened in the United States.*** This weakness has three main sources: the usual inventory correction, a drastic cut in business fixed capital spending and a sharp slowdown in consumer spending.

Consumer spending was by no means immune to the downturn. It has kept growing, but at a sharply diminished pace. Its contribution to real GDP growth in the third quarter of 2001 was less than one-fourth of what it had been in the same quarter a year before: 0.83 versus 2.88 percentage points. Compared to past recessions, this was an unusually sharp decline. Fixed business investment shaved 1.45 percentage points off GDP growth, as against a positive contribution of 0.44 percentage points a year ago.

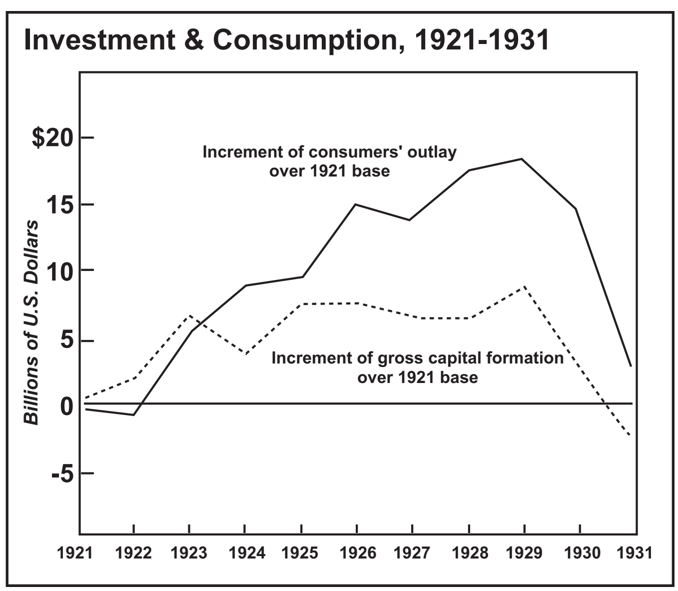
Manifestly, the capital-spending bust is the economy's primary and dominant depressant. Plunging employment and production in the capital goods industries translates directly into lower consumers' incomes and spending. Remember John Maynard Keynes' multiplier. Declines in capital spending, both residential and non-residential, are regular features of economic downturns. Yet two things are unusual this time: residential building remains strong while business fixed investment has dived faster than normal. Actually, it is not just the decline that counts. Rather, it is the difference between the former steep increase and current slump. As recently as a year ago, the production of high-tech gear — including computers, communications equipment, peripherals and semiconductors — was growing at nearly 60% a year. Since late 2000, output has shrunk 15%.

GEARED TO CONSUMPTION

Pursuing the economic discussion in the United States, it strikes us that one theme is preponderant: consumer confidence and consumer spending. As opposed to this virtual obsession with consumption, the devastating slump of capital spending and profits finds amazingly little attention. You might think this is not a profit-oriented, capitalist economy. The fact is, we are looking at an economy that is geared to an unusually high rate of personal consumption and, as its counterpart, to unusually low rates of net saving and net investments.

For policymakers and economists in America, consumer spending is the most important GDP component that crucially determines the growth of domestic demand, and in consequence the level of capital spending. In this model, consumer spending leads, and investment spending follows. Accordingly, the policies of all presidents were primarily aimed at stimulating consumption. The obvious underlying assumption was and still is that rising demand for consumer goods is the best way to induce higher investment spending.

This policy bias is generally ascribed to Keynes. Mistakenly. The pro-consumption and anti-savings bias of American policymakers and economists goes back to the 1920s. Among the most famous first believers were Herbert Hoover and Henry Ford. Several books by two men fascinated America at the time — William T. Foster and Waddill Catchings. In their books — *The Dilemma of Thrift* and *Business Without a Buyer* — they trash the theme that saving causes depression. A main thesis of their books was: *"The one thing that is needed above all others to sustain a forward movement of business is enough money in the hands of consumers."* Their solution was consumer credit. In 1936 this argument induced President Franklin Roosevelt to pay a cash bonus to war veterans, amounting to $1.9 billion, or more than 2% of GDP. It failed to prevent a new collapse of the economy.



Contrary to prevailing opinion, the boom of the 1920s was far more a consumption boom than an investment boom, the first of this kind in history. It centered in the rise of the automobile. The tripling of automobile production was the single biggest force for economic growth in the boom, and it propelled similar growth in related industries, such a steel, rubber and highway construction. But by no means was it only new technology and the bull run of the stock market that stoked the auto boom. It was made possible through another watershed innovation that enabled

millions of lower- and middle-class people to buy the car without having the money. This innovation happened in the financial sphere and was the invention of consumer installment credit.

For the first time in history, consumers could spend large sums in excess of their current income. Both installment and mortgage debt exploded. Such lending was anathema to bankers, who were used to making loans only to businesses and farmers, where the collateral was a productive, income-creating asset. As a result, the auto companies stepped in and offered the credits themselves. From there, the idea spread to all sorts of consumer durables.

This run-up of consumer confidence happened against a backdrop of pervasive confidence in both the strength of the U.S. economy and unbridled trust in the Federal Reserve's ability to smooth out the economy's ups and downs. As one historian wrote of the period: *"A doctrine began to emerge which held that the United States had both an opportunity and an obligation to chart a fresh and unique course towards human betterment… The United States had a mission to serve humanity by demonstrating the superiority of a distinctive 'American way.'"* Sounds familiar, doesn't it?

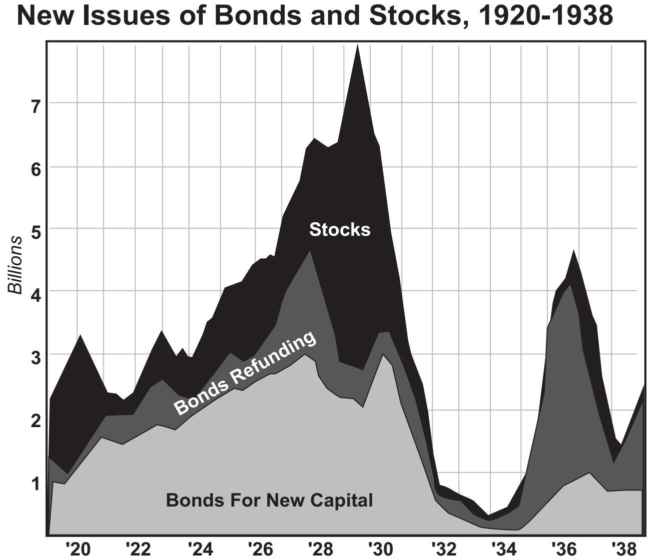
In reality, it was not consumer spending *per se* but soaring consumer indebtedness that drove the U.S. boom of the 1920s. Thanks to Milton Friedman, the following Great Depression had its single, decisive cause in the Federal Reserve's failure to slash interest rates fast enough, turning a potential garden-variety recession into a deep, prolonged depression. What had happened in the economy and the financial system during the boom had no relevance for him.

A LESSON FROM 1930

The first precursor of the coming storm was a sharp slowdown in auto production in the spring of 1929, following a record-high production of 4.7 million cars during the prior 12 months. After peaking in April 1929, factory production of passenger cars plunged by 70% until the fourth quarter. Essentially, the supplier industries, above all steel and rubber, followed suit, impacting large parts of manufacturing, though mostly at a much more moderate rate. But as large slides had happened before, few people were immediately concerned. The great shock to the prevailing complacency occurred more than a year after the stock market crash, in late 1930, when production continued to fall and serious troubles in banking and the credit markets surfaced.

The automobile had been the backbone of the prior boom both in the economy and in the stock market. That the sudden slide of the boom's key component sent the whole economy and the stock market reeling was hardly surprising. Nor was the sudden slide itself surprising. The steep rise in the purchase of new cars was clearly not sustainable. It is the nature of such spending bursts that they abruptly end. On top of the automobile slump came the immediate export slump and the deepening, structural agricultural crisis.

New Issues of Bonds and Stocks, 1920-1938



Together, these major drags made for a dramatic contraction of the U.S. economy in 1930, with or without tight money. But what definitely and crucially protracted and deepened the developing recession was the complete disruption of the financial markets, first of the stock market in late 1929, and later in the 1930s in corporate bonds. As the deteriorating economy was rapidly turning a growing part of bank bond portfolios into junk, their plunging market value ravaged the banks' balance sheets. The fact that prices of high-grade bonds remained stable, implicitly suggests that the unfolding crisis both of the banking system and the

credit markets had its overriding cause not in monetary tightness and a scramble for liquidity but in deteriorating credit quality, or rather in the circumstance that lenders, both banks and investors, virtually stopped lending, apparently fearful of the rapidly deteriorating credit quality. The outstanding financial event during the year was the abrupt collapse of security issuance. The chart on page 3 tells you more about the cause of the Great Depression than Milton Friedman's whole book.

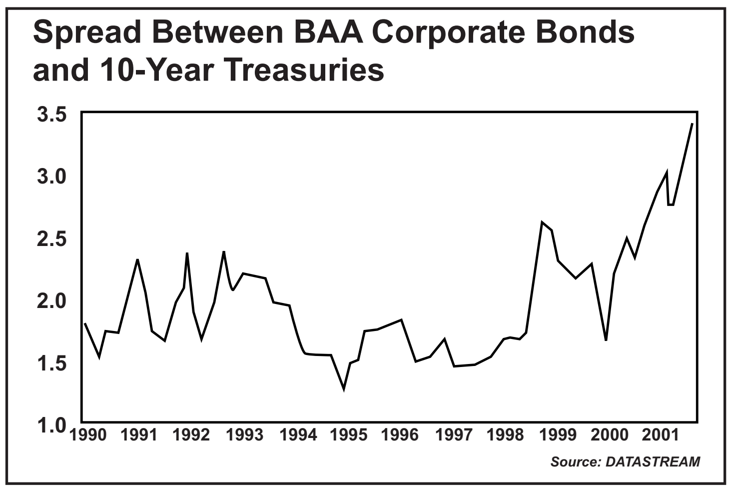
We are drawing attention to this experience of 1930 because we are sure that a very similar experience is waiting to happen again in the United States.

THE KEY: PROFIT IMPLOSION

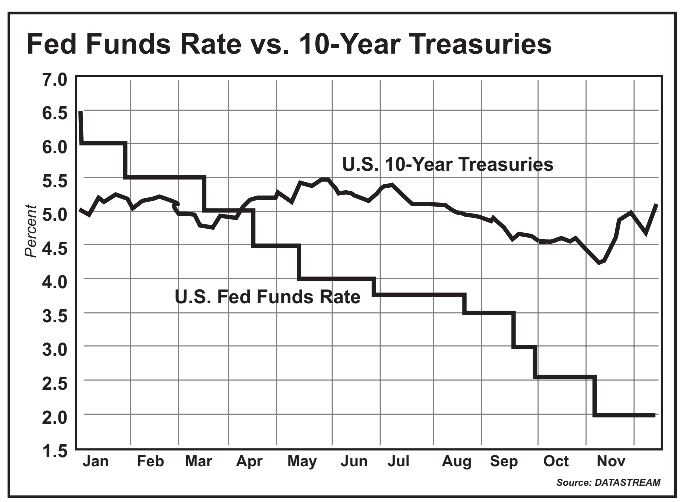
Drawing comparisons, a first point to realize is that corporate balance sheets are in grossly worse shape today than they were in 1929-30. It has its obvious reason in the fact that the corporations during the two periods pursued diametrically opposite financial strategies. In the 1920s, they utilized the strong stock market to strengthen their equity base and their balance sheets (see the previous chart), while in the 1990s they systematically ravaged their equity base with massive stock buybacks in order to lift their rates of return per share. As a result, debts have soared in relation to equity as never before in history. In addition, dividend payments were boosted at the expense of retained earnings.

Looking again to the year 1930, it apparently was a mixture of worsening economic news, plunging business profits and a broad slide in the market value of corporate bonds that abruptly stopped the whole credit machine. Against these powerful, contractive market forces, the Fed's rapid rate cuts had no chance.

The parallels to the present are manifest. Delinquencies and bankruptcies are escalating. Credit spreads have soared. For the reasons explained, corporate balance sheets are far weaker today than in 1929-30. In previous postwar recessions, retrenchment in capital spending reduced firms' need for credit and slowed the growth of debt. This time, cuts in capital spending have been aggressive as never before, but corporate borrowing-needs remain unusually high because the internal cash flow is falling almost as fast.



Federal Reserve figures show that the corporate financing gap — that is, the excess of capital spending over cash flow — hit an almost unprecedented peak of 3.3% of GDP at the end of 2000. But though capital spending has been slashed, vanishing retained earnings are keeping the financial gap unusually high. In the second quarter of 2001 it still stood at $250 billion, accounting for 27% of corporate fixed investment. For an economy in recession, this is an extremely high financial gap.



Plainly, U.S. corporations have entered this recession with the weakest balance sheets ever, far weaker than in 1929-30. Downgrading by the rating agencies is escalating, causing rapidly rising credit spreads.

But corporations, like the consumer, continue to enjoy lavish credit accommodation. That's the great difference to 1930, so far. Bond issuance has soared

to unprecedented levels. But who is buying this deluge of bonds in an economy where net saving of businesses and consumers is zero or negative? The essential domestic source is limitless financial leveraging — borrowing short at rock-bottom rates and investing long. The Fed just reported that total credit (financial and nonfinancial) grew in the third quarter at an annualized pace of $2.235 trillion, or 8.1%, to $28.874 trillion, the highest growth rate since the fourth quarter of 1999. And there has been a second very big buyer of U.S. corporate and government-agency bonds — foreign investors. Look at the dollar.

THWARTED MONETARY POLICY

Many observers certainly regard this rampant credit expansion as Mr. Greenspan's great success. They overlook that availability of credit is but one of four different channels through which monetary policy impacts the economy. The other three are the interest rate channel, the exchange rate channel, and the asset valuation or balance sheet channel.

These latter three channels have something in common that the channel of credit availability completely lacks. They directly impart positive effects to corporate balance sheets and competitiveness. As to the interest channel, it is most important that the Fed's rate cuts translate as much as possible into lower long-term rates. During 1990-93, a steep decline of the corporate interest bill accounted for two-thirds of the profit increase during these years. But this time, long-term rates have stayed stubbornly high. Rather, rising credit spreads increase borrowing costs in the midst of recession.

In short, the highly important interest rate channel is clogged for the corporations. And the same is also true for the other two transmission channels: the exchange rate and asset valuation. While the stock market has recovered, losses of several trillion dollars prevail. The strong dollar may be a blessing for the financial markets, but for manufacturing it is poison.

The all-important point to see is that Mr. Greenspan's very aggressive monetary easing is a complete flop in its effects on the monetary transmission channels.

NO GARDEN-VARIETY TYPE

Pondering the possibility or probability of an impending U.S. economic recovery, our focal point is corporate balance sheets and profits. As we have repeatedly stressed, both are in unusually bad shape, probably their worst since the Depression. Corporate indebtedness has soared out of all proportion to the profit-earning, productive capital stock. Of course, balance sheets have been deteriorating for many years without apparent harmful effects, but sometime and somewhere inherently comes the inevitable breaking point.

Many considerations have led us to the conclusion that a V-shaped recovery of the U.S. economy is absolutely impossible as far as the eye can see. But the key consideration is the miserable profit performance and its negative effects on capital spending for a long time to come. All recessions of the past that ended in such sharp recoveries had mainly reflected inventory and building corrections. The predominant feature of the current downturn, however, is a slump in business capital spending, primarily caused by a profits crisis.

It is an empirical fact that all recessions of unusual severity and duration reflected prolonged slumps in fixed investment, both residential and non-residential. A steep plunge particularly in commercial building was the salient feature of the U.S. economy's extended weakness between 1989-93. During the boom of the 1920s, building reached its high already in 1925, but remained at its high level nevertheless until 1928. The really precipitous drop came in 1929, prior to the collapse in general business activity.

In the recent U.S. boom, residential building actually peaked in early 1999. Since then, it oscillates at a high level with minimal contributions to real GDP growth. In the view of the optimistic consensus, this is a great positive for the economy. Looking backward, this is true. But looking forward, it is a big negative as it leaves little room for an upturn in building. Violent recoveries in residential building have been the notorious and also probably the most important feature of past brisk recoveries from recession in the United States. See the *Quarterly Review Summer 1993* from the Federal Reserve Bank of New York.

From that same study are the following numbers showing the pattern of the U.S. economy's last four recoveries:

PERCENTAGE CHANGE IN MAJOR ECONOMIC INDICATORS: FIRST EIGHT QUARTERS OF RECOVERY

	1991 I to 1993 I	1982 IV to 1984 IV	1975 I to 1977 I	1970 IV to 1972 IV
Real GDP	4.2	11.6	9.9	10.5
Personal consumption	4.4	9.7	10.7	11.6
Producers' durable equipment	18.6	31.2	15.0	24.3
Nonresidential structures	-13.7	9.4	0.7	3.8
Residential investment	23.7	51.5	47.3	42.6
Industrial production	6.2	16.6	16.5	17.9
Private employment	0.5	9.2	6.0	6.2
Unemployment rate	0.5	-3.4	-0.8	-0.6
Real disposable income	4.4	10.1	7.9	11.1
Real wage and salary income	1.9	9.1	6.0	10.0

Source: Federal Reserve of New York, Quarterly Review, Summer 1993

Since WWII the United States has experienced seven recessions. Ensuing recoveries were regularly V-shaped, except the one that followed the recession of 1990-91. In contrast to prior garden-variety recessions of the inventory-type, this one had its primary cause in a sharp, prolonged downturn of building, in particular of commercial building, following prior gross excesses in this area. Depressed building led to several years of unusually slow economic growth with protracted sluggishness across the board. What's more, plunging commercial real estate prices set the pace for a financial crisis, gripping the banks and above all the savings and loans.

The Business Cycle Dating Committee waited until December 1992 to declare that the recession had really ended 18 months earlier. The weakest of all the aggregates during this anemic recovery was employment growth. It continued to fall well into the recovery, strikingly reflected in a big jump in productivity growth (3.4% in 1992).

HIGH-CONSUMPTION, LOW INVESTMENT ECONOMY

Why was that recovery so anemic? Posing this question, the present is, of course, uppermost in our mind. Putting it differently, what is needed to produce a V-shaped recovery? At issue is a decade-old bone of contention between American and European economists about the cause or causes of economic growth and the business cycle. American economists emphasize the vital role of consumer spending and consumer confidence in this respect. According to this view, rising consumer demand is the main motive for businesses to invest. The fact that consumer spending has so far proved rather resilient is one of the favorite arguments for the coming recovery.

The key aspect is consumer confidence. News of changes in the popular confidence indexes attract great attention. Keeping up consumer confidence is regarded as the most important task of policymakers. The state of the consumer's finances and the source of his spending are hardly considered. It's a rather mystical belief in his determination to spend and to purchase. Just as nebulous or non-existent are the considerations how the higher consumer spending translates into the famous V-shaped recovery.

PROFITS VS. CONFIDENCE

Frankly speaking, this whole debate strikes us as unbelievably simplistic. Starting with the assumption that central banks and governments ought to prevent any recession, business cycle theory is an unwritten leaf in

American economics. In Continental Europe, it has been the heart of economics. Its aim was to explore the objective causes that seem to determine and control the business cycle. In short, it was a search for causalities. These economists would have laughed at the idea that surveys of the broad public could be helpful in assessing the economic outlook.

Their key focus was on profits and profit prospects, together with induced capital investment. Profits are both the cause and effect of the business cycle. But from a long-term perspective, they are more cause than effect. In our profit-seeking economies, they are the mainspring of both long-run growth and short-run cyclical fluctuations. Wesley Mitchell, too, the spiritual father of American business-cycle research (Business Cycles, 1913), though generally skeptical of tracking causalities, emphatically stressed that the quest for profits is the central factor behind economic growth and the fluctuations of the business cycle. Accordingly, he disputed that confidence could play an independent role.

After this brief review of the contrast between American and European thinking about the business cycle, now back to the most important issue of today: the possibility or impossibility of an imminent, vigorous U.S. economic recovery. What we hear and read so far has little or nothing to do with business cycle research. It is all hollow phrases and blind confidence that the occurring rampant money and credit creation cannot fail to work. We would say they are compelled to believe this simply because it is too frightening to disbelieve. Our analysis of the objective economic and financial conditions compels us to disbelieve and to warn about it.

The biggest reason for optimism, according to what we read, is the surprising resilience of the consumer. But such resilience is the typical feature of all recessions. During four out of seven U.S. recessions in the postwar period, consumer spending never went negative. Considering that this is a highly critical juncture for the U.S. economy, one would expect a most careful scrutiny of the published economic data. A rebound in orders for durable goods in October by 12.8%, as against a drop by 9.2% in September, was immediately hailed as an important recovery sign. In reality, the whole of the gain had come from a jump in defense orders (+206%) and automobile orders (+38.8%, reflecting their surge in sales). Except for these two extraordinary items, durable goods orders had continued to slide.

It used to be common knowledge among economists that the pattern and the magnitude of the excesses that have accumulated during the boom determine the pattern and the severity of the following recession. If this is true, and we think it is, then there is nothing more ridiculous than the talk of a V-shaped recovery.

A STRUCTURAL CRISIS

Manifestly, the economic and financial excesses that have built up in the U.S. economy during the past four to five boom years are the worst in history. The last time the U.S. economy experienced protracted weakness was from 1989 to 1993. Taking the actual credit expansion as a measure of excess, we note that during the second half of the 1980s, total credit (private nonfinancial and financial) in the United States had increased $3.4 trillion. In the second half of the 1990s, it expanded by more than $9 trillion.

What is still normal in an economy with such an insane credit explosion? We presume, nothing. Looking only at the most obvious and the most spectacular, unsustainable imbalances is more than shocking, it is frightening: grossly overvalued equities, near-zero personal savings, the monstrous trade deficit, steeply rising trillions of foreign debts, a hugely overvalued dollar, badly weakened corporate balance sheets, the lowest corporate profitability in the whole postwar period, and a financial system that is founded on the most fantastic leverage.

This is a virtual Pandora's box of interrelated and interdependent bubbles, and the one thing that is keeping all these bubbles afloat is the illusion of an imminent V-shaped recovery and blind faith in the magic of Mr. Greenspan.

Who or which demand component could possibly lead the predicted U.S. economic recovery? Rising capital spending by debt-laden corporations confronted with collapsing profits? Or higher spending by the debt-laden

consumer confronted with huge wealth losses in the stock market, rising employment and stagnating or shrinking disposable income?

Nobody can say for sure what exactly is going to happen; yet one thing is beyond any doubt: the V-shaped U.S. economic recovery is impossible. It is impossible for the simple reason that this typical recovery pattern depends on a typical recession pattern: strong cyclical fluctuations in inventories and residential building. Once the inventory correction ceases, production spurts back. This typical rebound did not and could not happen after the 1990-91 recession because commercial building went through the wringer of a financial crisis. And this time, the V-shaped recovery cannot and will not materialize because the present recession has its root causes in a profits and capital-spending crisis.

WHAT MAKES FOR V-SHAPED RECOVERIES?

There may be a general presumption that the excesses of the information technology both in the stock market and in the economy have been worked off. As to stock valuations, this is obviously not the case at all. As profits have fallen even faster than share prices, P/E ratios are sky-high, in many cases higher than ever. And as to the corporate capital-spending crisis, there is definitely nothing in sight that might stop the underlying profits crisis. Furthermore, another most important negative aspect is the unusual situation in residential building. Immediate, big jumps in residential building in response to monetary easing have been a key feature of past V-shaped recoveries. Remaining at record-high level, the stable housing sector has crucially helped to prevent a sharper economic downturn, but with the implication of little or no upward potential in future.

Putting it bluntly: The U.S. economy's V-shaped recovery early next year depends altogether on a double-digit burst in capital spending, both residential and non-residential. This is the indispensable, crucial condition for such a recovery. The widespread view of consumer spending as the critical demand component that leads all cyclical recoveries goes flagrantly against all empirical evidence. Whether up or down, consumer demand is always lagging investment spending. Of the seven recessions that the United States has experienced since WWII, six ended in a "V-shaped" recovery, all of them plainly driven by a burst in residential and non-residential capital investment. The one exception was the frail recovery from the 1990-91 recession, and its frailty had its manifest cause in plunging commercial building together with subpar growth of residential and nonresidential investment.

And how about next year? We would say that there is definitely no ray of hope in sight for such bursts in investment spending that are typical of V-shaped cyclical recoveries. Both residential and commercial building have been so kind as to remain at a high level, but that also speaks against the possibility of an imminent big bounce. As to business capital spending, the objective facts of the horrible profit picture and the declining capacity utilization make it even more difficult to imagine any recovery.

THE FATEFUL YEAR 1998

Discarding any possibility of a V-shaped U.S. economic recovery, we keep mulling the question what will happen to the financial markets — stocks, bonds and the dollar — when this disappointing recognition begins to sink into people's mind. The continuous credit explosion should not delude about the fact that for an increasing number of firms, funding is meeting difficulties. Further economic deterioration is sure to increase these difficulties. Don't forget that the U.S. fixed income markets temporarily seized up in 1998 in the wake of the Russian default and the Long-Term Capital Management crisis. An orchestrated rescue, three slight rate cuts by the Fed and a further booming economy brought the markets back to life. Over and above, the financial disturbance had come from abroad — Asia and Russia.

Looking back, 1998 stands out as the great inflection point in the U.S. economic and financial development under Mr. Greenspan. From then on, everything went to new extreme excess, particularly the financial system. Over just three years, from mid-1998 to mid-2001, financial and nonfinancial borrowing erupted $6.5 trillion, or 36%. Financial institutions increased their borrowing by $2.9 trillion, or almost 50%, to $8.8 trillion. Among

them, outstanding agency (GSE) securities rose $1.6 trillion, or 54%, to $4.6 trillion. Securities Broker/Dealer liabilities soared $396 billion, or 46%, to $1.28 trillion. Outstanding asset-backed securities jumped $716 billion, or 59%, to $1.94 trillion. The private nonfinancial sector, that is, corporations and consumers, piled up a new indebtedness of $3.3 trillion, up 27%. And what happened to economic activity? Measured in dollars, U.S. GDP grew $1.42 trillion, or 16%. Clearly, the U.S. financial system leads a life of its own, completely unrelated to economic activity.

After the LTCM rescue, credit creation in the United States ran completely out of control. It was sheer financial insanity. Nevertheless, the economy's boom lasted only another seven quarters until mid-2000. Since then, it has been downhill for the stock market and the economy. What we are witnessing since then is unprecedented in history: an economic slide into recession with exploding credit. And more and more American economists lament about deflation.

Two things in this scenario amaze us. One is the unshackled credit explosion in the markets, and the other is the dollar's stability. Actually, they are connected. Foreign investors are big buyers. In 1999-2000, the current-account deficit was double-barreled funded by merger and acquisition flows and portfolio flows. In 2001, it was mainly the latter with a sharply rising part of foreign purchases of high-grade corporate and agency bonds offering vastly higher yields than the European bond markets. Manifestly, these huge capital inflows, matching the huge current account deficit, are playing a key role in keeping the U.S. credit markets afloat. That, by the way, is the crucial difference to 1998, when the markets seized up.

But it should also be clear that these portfolio inflows are entirely dependent upon one condition: the sustained perception that the U.S. economy is the healthiest and the strongest in the world and that it will be the first one out of this global recession. Plus, of course, blind faith in the monetary magic of Mr. Greenspan.

To us it is only a question of time when these perceptions will burst. For the reasons explained, it is a compelling conclusion for us that a meaningful economic recovery in the United States next year is completely out of the question. The evidence of a continuing downturn is overwhelming. But the general denial to see the dismal economic realities is even more overwhelming.

The most obvious most critical feature of the downturn is the extraordinary profits carnage fueling the bust in business capital investment that, in turn, bleeds consumer incomes. The essential implication is the continuous erosion of balance sheets and of credit quality. As corporations and consumers' finances are relentlessly deteriorating, growing credit troubles and a future credit crunch in the markets is definitely predestined. Bank lending to commercial and industrial companies is already in sharp contraction. On the other hand, issuance of corporate bonds has been expanding at record rate. Apparently, the markets are more generous, but looking at the big credit spreads that it charges, it is expensive money.

Leaving the New Economy propaganda aside, what was the most momentous change in the U.S. economy after 1998? One thing: the literal collapse of personal saving from $311 billion, at annual rate, in the third quarter to virtually zero in 2001, reflecting the wildest consumer borrowing and spending binge in history. For perspective: nominal GDP growth in the boom years ran at an annual rate of a little over $400 billion.

Intrinsically, this consumption binge has pulled resources away from other areas where demand was less pressing. Since government spending did not cede, these resources came mainly from two sources: lesser net investment and from borrowing abroad. Many years ago in his book *Economics*, Paul Samuelson described how one generation can raise its living standards at the expense of its children: by bequeathing them a smaller productive capital stock and a lot foreign debts. Other economists described it as "beggar-thy-children" policy.

DOES HE KNOW?

The fact is that economists of all schools of thought, American economists included, have at all times regarded the allocation of resources between investment and consumption as a question of paramount importance for economic growth and prosperity. During the 1980s, it was intensely debated whether the Reagan

tax cuts would raise savings or not. Today, in contrast, we continually read that stock market gains are a valid substitute for saving even though the soaring stock prices have the exact opposite effect to boost consumption.

Nobody has astounded us in the past years more than Mr. Greenspan, distinguishing himself permanently as the most prominent cheerleader of the stock market bubble and expressing things that to us didn't qualify him as a knowledgeable economist. He has always struck us as somebody who says most dubious things in a highly sophisticated manner that impresses people by conveying the impression that he is a most thoughtful person. On the other hand, he has never uttered a word about the credit deluge that he has unleashed. We have always wondered about the "true" Mr. Greenspan.

By sheer chance, among old files we came upon his congressional testimony of November 1988 concerning the negative effects of government deficits on economic growth. What it revealed to us was a knowledgeable economist who perfectly knew about the crucial importance of saving and the inherent resource allocation between consumption and investment for economic growth. In that testimony, he actually explained how government deficits, by absorbing savings, erode long-term economic growth. Here a few excerpts:

"Under these circumstances, such large and persistent deficits are slowly but inexorably damaging the economy: The damage occurs because deficits tend to pull resources away from private net investment. And a reduction in net investment has reduced the rate of growth of the nation's capital stock. This, in turn, has meant less capital per worker than would have been the case and this will engender a shortfall in labor productivity growth and, with it, a shortfall in growth of the standard of living…

"Government deficits place pressure on resources and credit markets only if they are not offset by saving elsewhere in the economy. If the pool of private saving is small, federal deficits and private investment will be in keen competition for funds and resources, and private investment will lose.

"The deficit already has begun to eat away at the foundation of our economic strength… If we do not act promptly, the imbalances in the economy are such that the effects of the deficit will be increasingly felt and with some immediacy…"

Obviously, he used to know about the crucial importance of saving in making real resources for net capital investment available. At the time, America's structural problem consisted of a high budget deficit and a low rate of personal saving. In essence, he warned that the large deficit left too little saving for net investment. Meanwhile, he has presided over years of exorbitant monetary looseness that drove private consumption to such excess that personal saving went into complete eclipse.

THE TRUTH: A POST-BUBBLE ECONOMY

Assessing the present economic situation in the United States has to start with the recognition that the protracted boom of the past several years went vastly in excess of the normal cyclical pattern. Credit excesses of unprecedented magnitude created economic and financial distortions and imbalances of equally unprecedented magnitude. What we are observing is therefore not the conventional cyclical backdrop of a conventional cyclical boom but the aftermath of a bubble economy.

The past 20 years have provided plentiful examples of asset bubbles. They typically happened in the building sector. Soaring real estate prices led to building excesses. But outside this sector, these bubbles had limited effects. Principally different cases were the U.S. experience with the stock market bubble of the late 1920s and Japan's experience with the stock market and real estate bubble of the late 1980s.

An asset price bubble turns into a bubble economy when the associated demand stimulation becomes pervasive for the whole economy and its financial system, involving a significant, unsustainable resource misallocation.

In the U.S. case of the 1920, the demand effects of the stock market bubble went mainly into consumer

spending, above all consumer durables. Business investment and building peaked in 1925. From then on, it was nothing but a consumer-spending boom. J.K. Galbraith, by the way, wrote about the end of the Great Depression: *"It did not, in fact, end. It was swept away by World War II."* We wonder whether President Bush and his advisers know about this fact. In Japan's case of the 1980s, the main demand effect of the bubble was on commercial building and business fixed investment. Consumers, too, stepped up their expenditures on housing and durables. But there was no borrowing binge on their part. Personal saving remained on a double-digit level.

Speaking of an imminent V-shaped recovery ought to begin with the question of its essential conditions. The ending of inventory liquidations helps. But the decisive push has always come from bursts in two demand components: residential building and equipment investment by businesses. Consumption always lags. The above-mentioned study by the New York Fed about the U.S. postwar cycles gave the average upward movement of the main aggregates during the first eight quarters of the five V-shaped recoveries, all in percent: GDP 10.2, personal consumption 9.9, business equipment 21.4, non-residential structures 4.8, residential building 36.7, industrial production 17.9, private employment 6.5, real disposable income 9.

Those who are forecasting an imminent V-shaped recovery in the United States plainly have no idea of its essence and indispensable conditions. There is little more then hope and hype about resilient consumer spending. Analyzing the cold, objective facts, we see no chance for the necessary booms in building and business capital investment, and that tells us there is not the slightest chance for a V-shaped recovery.

CONFIDENCE GAME

Mr. Greenspan and many others keep emphasizing the crucial importance of confidence for the economic outlook. Of course, it is highly important, but what kind of confidence? As we have repeatedly stressed, there is but one desirable kind of confidence: reasonable confidence in line with objective, underlying economic facts. The worst thing is artificial, false confidence. It is a historical fact that the worst economic and financial crises have been preceded by the greatest euphoria about the economic outlook. It is the key condition to induce the excesses that end in a crisis. In the late 1920s, Americans came to believe in a "New Era" for their economy; so did the Japanese in the late 1980s, and so it has happened again in the last U.S. boom.

Definitely, it cannot be said that this downturn in the United States has an important cause in a lack of confidence and pessimistic expectations. The exact opposite is true. Grossly inflated expectations about future prosperity, incomes and profits have suffered an overdue downward correction. Anything may have induced firms and consumers to retrench, perhaps the sudden slide of the stock market. But such retrenchment from unsustainable borrowing was bound to happen one day. Manifestly, it was not tight money and credit that did it. Basically, it is a post-bubble situation that has derived from a gross excess of confidence and expectations that kindled the unsustainable borrowing and spending excesses. Emphasis is on the word *unsustainable*.

THE BOTTOM LINE: PROFIT TAILSPIN

The decisive, relentless downward force in the U.S. economy, to repeat, is the profit tailspin and the associated tailspin in business capital investment. A recent article in the London *Economist*, stating that U.S. profit margins are at their lowest level since the Depression of the 1930s, stunned even us. But the author had drawn this conclusion by measuring profits as a share of GDP, while we have been looking at absolute amounts. His way of measuring, to be sure, is more correct and instructive. In the third quarter of this year, pre-tax profits of nonfinancial corporations were down 26% from a year earlier, to a level of 7.5% of GDP. As recently as 1997, that figure was 12.5%.

A profit decline over about 50 years must in essence be of structural nature. The author presumes lack of pricing power. Considering prolonged periods of high inflation rates, this hardly makes sense. We have another explanation: lack of investment. The main profit source from a macro perspective is capitalized net capital

investment expenditures, and this has been in permanent decline as a share of GDP, lately hitting the Depression lows. As we have often stressed, the U.S. economy is a high-consumption, low-investment economy, and that is in essence also a low-profit economy. Since 1998, massive consumer dissaving has provided strong support for profits. But since this has stopped, while net investment has gone negative, profits have only one way to go as far as the eye can see: from bad to worse and worse.

The economic risks are clear to see. What about financial risks? The financial system has coped well with a series of knocks over the past several years. But there are two important differences between past, present and future: These knocks came from abroad or from outside the economy, and they happened against the backdrop of a booming U.S. economy. Now the U.S. economy itself is the epicenter of trouble. Corporations are ravaging their balance sheets as never before in order to keep up the appearance of profitability. From 2000 Q3 to 2001 Q3, total domestic after-tax profits of financial corporations have slumped from $118.5 billion to $88.4 billion and of nonfinancial firms from $323.9 billion to $242.8 billion, all numbers annualized. Profits of foreign subsidiaries, by the way, are down 33.5% from a year earlier.

Yet dividend payments rose between the two quarters from $386.2 billion to $420.4 billion. Dividends generally decline in a recession. This time, they are rising. The result is the highest dividend payout ratio and the lowest rate of business saving (retained earnings) in history. Over the year to the third quarter 2001, it has plummeted from $197.2 billion to $53.9 billion. If this recession extends with further pronounced profit declines, credit problems will mushroom. The development of a general credit crunch, like in 1930, under these conditions seems only a question of time.

CONCLUSIONS:

The most important thing to realize about the present U.S. economic downturn is that its root cause is a savage profits crisis. Profit margins are at their lowest in the whole postwar period. This has several reasons, but high-tech production is the worst performer. Most of these firms' profits in the past few years came from huge gains in the stock market.

Another generally unrecognized major risk in the development is the extremely bad and still worsening shape of corporate balance sheets. This increasingly aggravates companies' already severe difficulties financing capital spending.

Downside risks remain overwhelming. For the time being, the markets are buoyed by trust in the predicted, imminent V-shaped U.S. economic recovery. Its failure to materialize will come as a tremendous shock to everybody with shattering effects for all segments of the financial markets — stock, bonds and the dollar.

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